CASE NOTE

A Growing Good Faith in Contracts

By

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1. Introduction

The topic of good faith generates considerable judicial attention worldwide and a significant volume of commentary and academic literature. As the Oxford University Obligations Group observe:

> "Good faith is a topic that has been written about at inordinate length, by an almost intolerably wide group of people – some worth reading, some not".[1]

This writer is guilty of being a contributor to this literary prolixity[2] and the recent decision of the Supreme Court of Canada in Bhasin v Hrynew[3] in motivating this case note will make for serial offender status. However the court's decision in this case merits attention as being "perhaps the most important contract decision of the past 20 years...."[4]

Anglo-Commonwealth jurisdictions have embraced as part of their jurisprudence an obligation upon parties to an insurance contract to act in good faith towards each other in the formation and performance of that insurance contract[5]. The origins of the duty have occasioned considerable debate

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[1] "Some Reflections on Good Faith in Contract Law", Oxford University Obligations Group, February 2012 , 1.

[2] Generally see H.K. Lucke, "Good Faith and Contractual Performance" in P D Finn (ed), *Essays on Contract* (Law Book Co, 1987), 155; E A Farnsworth, "Good Faith in Contractual Performance", in J Beatson and D Friedmann (eds), *Good Faith and Fault in Contract Law* (Clarendon Press, 1997), 155; A.F. Mason, "Contract, Good Faith and Equitable Standards of Fair Dealing" (2000) 116 Law Quarterly Review 66; J. Tarr, ' Utmost Good Faith in Insurance: Reform Overdue?' (2003) 10 Asia Pacific Law Review 171-184; E Peden, *Good faith in the Performance of Contracts* (Lexis Nexis Butterworths, 2003).

[3] 2014 SCC 71.

[4] D.Dias, "SCC establishes duty of honesty between contracting parties", http:// www.canadianlawyermag.com/legalfeeds/2379.

[5] See, for example, the Marine Insurance Act 1906 (UK), s17 which states that a contract of marine insurance is a contract based on utmost good faith; as amended by the Insurance Act 2015 (UK), s 14(3); Insurance Contracts Act 1984(Australia), s13 which states that it is a paramount obligation upon the parties to a contract of insurance that they observe utmost good faith towards one another in the formation and performance of the contract.

with the most accepted view being that the duty of utmost good faith and the duty of disclosure are not based on an implied term in the contract, nor significantly are these duties limited to insurance contracts[6]. These duties, according to the accepted view, are common law duties arising outside of the contract and applicable to all contracts of utmost good faith. As the High Court of Australia explained in *Khoury v Government Insurance Office (NSW)*[7] the duty of disclosure was an obligation which was imposed by the common law as *an incident of the relationship between insurer and insured*. The Court pointed out that there were numerous conceptual difficulties in basing this duty on an implied term of the contract of insurance; for example, the duty of disclosure was logically anterior to the making of the contract and to treat it as a special implied term lay ill with the general rule that the dealings of parties preliminary to a formal contract were not part of the contract itself.

In *Iscor Pension Fund v Marine & Trade Insurance Co Ltd* [8]the South African court, struggling with similar information asymmetry issues in service provisions, observed that in some contracts parties are required to place their cards on the table to a greater extent than in others, but the determination of the extent of the disclosure does not depend on the label "we choose to stick on a contract." This statement captures the essential foundation of the obligation; namely, that it is the relationship between the parties that is crucial to the determination of the obligation(s) between them. A good statutory example of this is to be found in an unfair contract terms provision in the Consumer Rights Act 2015(UK). In regulating the operation and effect of terms in contracts between consumers and businesses, a relationship that most commonly will reflect an imbalance in the relative bargaining strengths and knowledge of the parties, a good faith brake is inserted. Section 62(4) of this Act states that a term is unfair if, contrary to the requirement of good faith, it causes a significant imbalance in the parties rights and obligations under the contract to the detriment of the consumer.

Similarly the High Court in England in the recent case of *Bristol Groundschool Ltd v Intelligent Data Capture Ltd*[9] implied a duty of good faith in a contract under which the parties had collaborated on producing training manuals for commercial airline pilots. Critical to the court's decision was its finding that the agreement in question was a "relational" contract, an expression used by Leggatt J in the earlier case of *Yam Seng Pte Ltd v International Trade Corporation Ltd*.[10] In the *Yam Seng* case Leggatt J observed that English contract law had not historically recognised a legal principle of good faith of

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[6] See for example, *Khoury v Government Insurance Office(New South Wales)* (1984) 165 CLR 622; *Banque Financiere de la Cite SA (formerly Banque Keyser Ullmann SA) v Westgate Insurance Co Ltd (formerly Banque Hodge General & Mercantile Co Ltd)* [1991] 2 AC 249; [1990] 3 WLR 364; [1990] 2 All ER 947; *The Star Sea* [2001] UKHL 1, [2003] 1 AC 469; *CGU Insurance Limited v AMP Financial Planning Pty Ltd* [2007] HCA 36; S.G. Bower, *The Law Relating to Actionable Non-disclosure: And Other Breaches of Duty in Relations of Confidence, Influence and Advantage*, rev A.K. Turner and R.J. Sutton, 2 ed, (Sweet & Maxwell,1990).

[7] (1984) 165 CLR 622.

[8] [1961] 1 SA 178.

[9] [2014] EWHC 2145 (Ch).

[10] [2013] EWHC 111(QBD).

general application but rather its implication by law in some categories of contract such as employment contracts, partnership agreements and agreements involving fiduciary relationships. He stated that this reluctance was misplaced and that a duty of good faith should be implied into ordinary commercial contracts especially where those contracts might be characterised as "relational contracts"; namely, contracts which require a high degree of communication, co-operation and predictable performance based on mutual trust and loyalty and which involve expectations of loyalty which are implicit in the parties understanding and necessary to give business efficacy to the arrangements"[11]. In applying this reasoning in the *Bristol Groundschool* case the court held that the unauthorised downloading of material by one party was commercially unacceptable and in breach of the implied duty of good faith, the relevant test being whether the conduct in question would be regarded as commercially unacceptable by reasonable and honest people in the particular context involved[12].

These cases suggest an emerging doctrine of good faith of general application to all commercial contracts but this matter is by no means resolved in all common law jurisdictions.[13] However, at least in Canada the position is now clear and the Supreme Court of Canada's decision contains analysis and reasoning that may be extremely helpful in promoting a unified treatment of this topic across the common law world.

2. Bhasin v Hrynew[14]

The Supreme Court of Canada in *Bhasin v Hrynew* considered the operation of a discretionary renewal clause in a commercial dealership agreement. Canadian American Financial Corp. Canada Ltd ('The company') marketed education savings plans to investors using retail lenders known as enrolment directors, to sell their plans. The appellant in this case ('Bhasin') was an enrolment director operating a small business. The respondent was the company and Mr Hrynew ('Hrynew'), another enrolment

[11] At [134] – [153].

[12] At [175]. See also *Emirates Trading Agency Llc v Prime Mineral Exports Private Ltd* [2014] EWHC 2104 (Comm) where the court found that a dispute resolution clause, which was an agreed term in an existing and enforceable contract, requiring the parties to seek to resolve a dispute by 'friendly discussions' and within a limited period of time before the dispute may be referred to arbitration was enforceable. This imposed a binding obligation to negotiate in good faith.

[13] For example, in *Mid Essex Hospital Services NHS Trust v Compass Group UK and Ireland Ltd* [2013] EWCA Civ 200 the United Kingdom Court of Appeal did not regard the Yam Seng case as purporting to establish a general doctrine of good faith. Similarly in *Royal Botanic Gardens and Domain Trust v South Sydney CC* (2002) 186 ALR 289 the High Court of Australia acknowledged the "debate in various Australian authorities governing the existence and content of the implied obligation or duty of good faith and fair dealing in contractual performance and the exercise of contractual rights and powers" (at p.301). As the litigants before the court accepted the existence of such an obligation in the determination of a rental dispute, the Court resolved not to consider the existence and scope of the good faith doctrine. See also *Bobux Marketing Ltd v Raynor Marketing Ltd* [2002] 1 NZLR 506.

[14] 2014 SCC 71.

director. The contract between the Bhasin and the company provided that the term of the contract was three years and that the contract would automatically renew at the end of the three-year term unless one of the parties gave six month's written notice to the contrary.

The company decided not to renew its agreement with Bhasin and he brought an action against the company and Hrynew, claiming that the company's conduct constituted a failure to act with good faith and breached an implied term in the contract that decisions about whether to renew the contract would be made in good faith. The trial judge agreed, but his decision was unanimously overturned by the Alberta Court of Appeal. The appellate court did not consider it necessary nor appropriate, in these circumstances, to interfere with a contract that was clear and unambiguous on its terms. The Supreme Court of Canada restored the decision of the trial judge.

It was found that Hrynew had pressured the company into the decision not to renew the agency and that the company had dealt dishonestly with Bhasin in giving in to this pressure. Hrynew, who operated the largest agency in Calgary and who enjoyed a good working relationship with the Alberta Securities Commission('ASC'), which regulated the company's business, had long wanted to capture Bhasin's lucrative niche market. Hrynew had approached Bhasin on several occasions proposing a merger of their agencies, actively encouraged the company to force the merger and made veiled threats that he would leave if no merger occurred. The proposed merger was in effect a hostile take over of Bhasin's agency, and not surprisingly Bhasin steadfastly refused to participate in such a merger. During this time period the ASC had raised concerns about compliance issues among the company's enrolment directors and when the Comission required the company to appoint a single provincial trading officer to monitor compliance Hrynew was appointed. This role required Hrynew to conduct audits of the company's enrolment directors. Bhasin and another enrolment director objected to having Hrynew, a competitor, review their confidential business records.

The company, without consulting Bhasin, held discussions with ASC outlining the restructuring of its agencies and plans to have Bhasin working for Hrynew's agency. Further the company misled Bhasin by telling him that Hrynew as the provincial trading officer was obliged to treat information confidentially and that the ASC had rejected a proposal to have an outside independent person discharge this role – neither statement was true. The company also responded equivocally when Bhasin asked whether a merger was a 'done deal', and threatened to terminate the agreement when Bhasin continued to refuse to allow Hrynew to audit his records. At the expiry of the contract term, Bhasin lost the value in his business in his assembled workforce and the majority of his sales agents were successfully solicited by Hrynew's agency. Bhasin was obliged to take less remunerative work with one of the company's competitors.

In resolving in favour of Bhasin, the Supreme Court of Canada noted that Anglo-Canadian common law "has resisted acknowledging any generalized and independent doctrine of good faith in the performance

of contracts"[15] with consequence that the common law is piecemeal, unsettled and unclear. The court concluded that two incremental steps were necessary to make the common law more coherent and more just; namely:

- Acknowledge that good faith contractual performance is a general organizing principle of the common law of contract which underpins and informs the various rules in which the common law, in various situations and types of relationships, recognizes obligations of good faith contractual performance[16].
- Recognize, as a further manifestation of this organizing principle of good faith, that there is a common law duty which applies to all contracts to act honestly in the performance of contractual obligations.

The court stated that by taking these two steps a duty would be established that is just, accords with the 'reasonable expectations of commercial parties and is sufficiently precise that it will enhance rather than detract from commercial certainty'[17].

Cromwell J in delivering reasons for the judgment (McLachlin CJ, and LeBel, Abella, Rothstein, Karakatsanis and Wagner JJ concurring) stated that this organizing principle requires that parties generally must perform their contractual duties honestly and reasonably and not capriciously or arbitrarily. Moreover the learned judge observed that this organising principle states in general terms a requirement of justice from which more specific legal doctrines may be derived. An organizing principle therefore is not a free-standing rule, but rather a standard that underpins and is manifested in more specific legal doctrines and may be given different weight in different situations. It is a standard that helps to understand and develop the law in a coherent and principled way[18]. Accordingly the organizing principle of good faith:

> "... exemplifies the notion that, in carrying out his or her own performance of the contract, a contracting party should have appropriate regard to the legitimate contractual interests of the contracting partner. While "appropriate regard" for the other party's interests will vary depending on the context of the contractual relationship, it does not require acting to serve those interests in all cases. It merely requires that a party not seek to undermine those interests in bad faith. This general principle has strong conceptual differences from the much higher obligations of a fiduciary. Unlike fiduciary duties, good faith performance does not engage

[15] At [32].

[16] At [33].

[17] At [34].

[18] At [64]

> duties of loyalty to the other contracting party or a duty to put the interests of the other contracting party first. "[19]

The Supreme Court expressly acknowledged that the principle of good faith had to be applied in a manner that was consistent with the fundamental commitments of the common law of contract which generally places great weight on the freedom of contracting parties to pursue their individual self-interest. Cromwell J comments that:

> "In commerce, a party may sometimes cause loss to another — even intentionally — in the legitimate pursuit of economic self-interest. Doing so is not necessarily contrary to good faith and in some cases has actually been encouraged by the courts on the basis of economic efficiency. The development of the principle of good faith must be clear not to veer into a form of *ad hoc* judicial moralism or "palm tree" justice. In particular, the organizing principle of good faith should not be used as a pretext for scrutinizing the motives of contracting parties"[20].

Nevertheless under this new general duty requiring honesty in contractual performance, the Court stated that parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract. This does not impose a duty of loyalty or of disclosure or require a party to forego advantages flowing from the contract; it is a simple requirement not to lie or mislead the other party about one's contractual performance. Recognizing a duty of honest performance flowing directly from the common law organizing principle of good faith is an "appropriate incremental step"[21].

The court held that the company was liable for damages calculated on the basis of what Bhasin's economic position would have been had the company fulfilled its duty. It held that damages were to be assessed on the basis that if the company had performed the contract honestly, Bhasin would have been able to retain the value of his business rather than see it, in effect, expropriated and turned over to Hrynew.

3. Conclusions

This case is a significant step forward in harmonising the approach to good faith in contracting in an increasingly integrated global commercial environment.

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[19] At [65].

[20] At [70].

[21] At [92].

A general principle of good faith (derived from Roman law) is recognized by most civil law systems – including those of Germany, France and Italy. From that source references to good faith have already entered into English law via European Union legislation. For example, the Unfair Terms in Consumer Contracts Regulations 1999, which gives effect to a European directive, contains a requirement of good faith[22]. Similarly a general doctrine of good faith has long been recognized in the United States[23]. The Uniform Commercial Code, first promulgated in 1951, provides in section 1-203 that "every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." Similarly, the Restatement (Second) of Contracts states in section 205 that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and enforcement."

A Canadian contracts scholar, writing in 1984, commented that the common law has taken a 'kind of perverted pride' in the absence of any general notion of good faith.[24] It is submitted therefore that a broad recognition of a new common law duty of good faith applicable to all contracts is timely and, in the context of globalization of law and commerce, propitious, if not inevitable. As Posner J stated in *Market Street Associates Limited Partnership v Frey:*

> "The contractual duty of good faith is... not some newfangled bit of welfare-state paternalism or... the sediment of an altruistic strain in contract law..."[25]

[22] See Leggat J in *Yam Seng Pte Ltd v International Trade Corporation Ltd* [2013] EWHC 111 (QBD).Several other examples of legislation implementing EU directives which use this concept are mentioned in *Chitty on Contract Law* (31st Ed), Vol 1 at para 1-043

[23] The New York Court of Appeals said in 1918: "Every contract implies good faith and fair dealing between the parties to it": Wigand v Bachmann-Bechtel Brewing Co, 222 NY 272 at 277.

[24] J.Swan, "Whither Contracts: A Retrospective and Prospective Overview" in *Special Lectures of the Law Society of Upper Canada 1984 – Law in Transition: Contracts* (1984), 125, at 148; cited in Bhsin v Hrynew 2014 SCC 71, at [36].

[25] 941 F 2d 588 (1991), at 595; per Posner J.